UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

AMBAC ASSURANCE CORPORATION,

Plaintiff,

-against-

EMC MORTGAGE CORPORATION,

Defendant.

Case No. 08 Civ. 9464 (RMB) (THK)

DEFENDANT EMC MORTGAGE CORPORATION'S RESPONSE TO PLAINTIFF AMBAC ASSURANCE CORPORATION'S OBJECTIONS TO JUDGE KATZ'S REPORT AND RECOMMENDATION ON ITS MOTION FOR LEAVE TO FILE AN AMENDED COMPLAINT

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Defendant EMC Mortgage Corporation ("EMC") respectfully submits its response to Plaintiff Ambac Assurance Corporation's ("Ambac") objections (the "Objections") to the Report and Recommendation by the Honorable Theodore H. Katz, United States Magistrate Judge, dated December 16, 2010 which recommended granting in part and denying in part Ambac's motion for leave to file an amended complaint (the "Report").

PRELIMINARY STATEMENT

Ambac now recognizes that its claim for securities fraud based on contractual subrogation is futile and it does not object to the Report's recommendation denying this claim. Likewise, Ambac has abandoned its pursuit of federal securities law claims against ten additional individual defendants as well as its attempt to add an additional plaintiff. However, in an effort to salvage its securities fraud and tortious interference claims in the face of the detailed and well-reasoned Report on these points, Ambac recasts its arguments by claiming they were somehow overlooked by Judge Katz when, in fact, they were directly addressed and correctly rejected. Just as the proposed new claims are futile, so too are Ambac's objections.

Ambac — although acknowledging that it was not a purchaser of securities — continues to argue that it should be equitably subrogated to the rights of the noteholders so that it can assert their securities law claims. After rejecting Ambac's now withdrawn contractual subrogation claim, the Report correctly found that equitable subrogation "is not so expansive as to give Ambac the right, as an equitable subrogee, to allege federal securities fraud claims on behalf of third-parties who are not signatories to, or the insureds under, the underlying insurance agreements." (Report at 42.) That recommendation should be adopted. Ambac's new argument that the noteholders are the "insureds" is not only misplaced, but stands as a belated effort by

Ambac to circumvent a clear, long-held limitation to the private right of action under the federal securities laws.

Likewise, the proposed tortious interference claim against proposed new defendant Bear Stearns & Co. Inc. (now known as JP Morgan Securities Inc.) is futile. Bear Stearns' alleged "interference" was privileged based on its economic interest in the activity of its affiliate, and such conduct is not actionable. Moreover, Ambac has not pleaded sufficient facts to show that the alleged interference was prompted by malice or that it employed fraudulent or illegal means to do so, rather than acting out of motivation to protect its own economic interest.

RESPONSE TO AMBAC'S OBJECTIONS

1. The Report Correctly Recommended That Ambac Is Not Entitled to Assert a Federal Securities Law Claim Based on Equitable Subrogation.

Ambac argues that as an insurer of certain losses of the trusts, it is equitably subrogated to the noteholders' right to bring direct federal securities law claims, for their own benefit, against EMC and Bear Stearns because the noteholders, as beneficiaries of the trusts, are effectively insured parties. (Ambac Obj. at 11-12.) Under the relevant insurance agreements, however, it is the trustee on behalf of the trust that is the insured party, not the noteholders. The equitable subrogation doctrine only allows the insurer to assert claims belonging to the insured — not to usurp control of direct claims that belong to noteholders and seek to collect on purported (but unfounded) claims that it does not even insure. Indeed, the doctrine of equitable subrogation is inapposite to the financial guaranty policies at issue here because Ambac has a legal relationship with EMC as the result of a series of agreements carefully defining their respective rights and remedies, including subrogation. Judge Katz was thus entirely correct in deciding that because "the Trusts do not have standing to pursue securities fraud claims against

EMC and Bear Stearns, . . . neither does Ambac," and the Report's conclusion that this claim is futile should be adopted. (Report at 42.)

a. The Trustees, Not the Noteholders, Are the Insured Parties Under the Relevant Policies.

Ambac argues for the first time in its Objections that the noteholders are the "insureds" under the relevant insurance policies because the policies were issued to the "trustees" instead of to the "securitization trusts." (Ambac Obj. at 11-12.) Ambac's argument attempts to focus the court on semantic differences, in disregard of the law. Under New York law, the trustee is the legal entity that holds the insurance policy and the entity to which insurance proceeds are paid. *See* SACO 2006-8 Policy, Forlenza Decl. Ex. 4; Jan 14, 2011 Whitney Decl. Ex. B (10/4/10 Tr. at 82:3-9). This is because the securitization trusts at issue here are New York common-law trusts that are *not* distinct legal entities, but, as the First Department has explained, are instead "realistically and economically a unit" operated by a trustee. *Reich v. Bankers Life & Casualty Co.*, 99 A.D.2d 457, 458, 471 N.Y.S.2d 287, 287 (1st Dep't 1984). All trust property — whether held by the trustee for a New York trust or by a securitization trust for a Delaware statutory trust — is always held for the benefit of trust beneficiaries. *See* 1 Scott & Ascher on Trusts § 2.2.3 (5th ed. 2010); *see also Intri-Plex Tech., Inc. v. Crest Group, Inc.*, 499 F.3d 1048, 1053 (9th Cir. 2007) (receipt of proceeds from insurer does not make the payee the "insured;" rather the insured is the entity the insurer acts "on behalf of"). Indeed, counsel for Ambac admitted to Judge Katz that in paying the proceeds, Ambac assumed obligations that belonged to the trusts and Ambac made payments that the trusts otherwise would have to make. *See* Jan 14, 2011 Whitney Decl. Ex. B (10/4/10 Tr. at 73:2-9).[1]

Judge Katz was therefore correct in determining that the fact policies are held "for the benefit of the Noteholders" is of no moment. (Report at 33.) That the noteholders benefit from payments from the trust simply does not make them insured parties. The noteholders are *not* parties to any of the insurance policies or Insurance and Indemnification Agreements ("I&Is"), or any of the other related documents Ambac cites. (Report at 33.) The noteholders have neither signed any agreements with Ambac nor paid any insurance premiums. *See* SACO 2006-8 I&I § 3.01(a), Whitney Decl. Ex. 4; BSSLT 2007-1 Indenture § 3.02, Whitney Decl. Ex. 6. Ambac had no obligation to see that the noteholders ultimately received any of the proceeds, and the noteholders had no right to sue Ambac for failure to pay. *See* SACO 2006-8 Indenture § 3.20(i), Whitney Decl. Ex. 2. For all these reasons, the Report was correct in concluding that the trusts were the insured, and not the noteholders.

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[1] Ambac is thus incorrect that the noteholders were "[t]he only persons upon whom a 'benefit of pecuniary value'" was conferred by the policies at issue (Ambac Obj. at 14) because Ambac's payment of insurance proceeds to the trustees conferred a clear pecuniary benefit to them by fulfilling the obligations otherwise owed by the trusts. *See Intri-Plex Techs.,* 499 F.3d at 1053 (recognizing that insurance "benefit" can take the form of an insurer's "payment directly to a third party to avoid the third party's claim").

b. The Report Correctly Found That Equitable Subrogation Applies to the Claims of the Insured, Which Do Not Include Section 10(b) Claims.

Given that the noteholders are not the insureds, Ambac's arguments about subrogation start and end with the meaning of that equitable principle: "Subrogation is the principle by which an insurer, having paid losses of its insured, is placed in the position of its insured so that it may recover from the third party legally responsible for the loss." *Winkelmann v. Excelsior Ins. Co.*, 85 N.Y.2d 577, 581, 626 N.Y.S.2d 994, 996 (1995). As Judge Katz explained, "the insurer can recover on a particular claim only if the insured could have recovered on that same claim." (Report at 36.) Because the Section 10(b) claims that Ambac purports to bring do not belong to the insured (to the trustee), equitable subordination is not available to Ambac in this case.

Here, the Section 10(b) claims that Ambac purports to bring belong directly to the noteholders, not to the insured-trustee. The Supreme Court has been clear on this point. The availability of private civil remedies for violations of the Exchange Act are limited solely to purchasers and sellers of securities. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). Indeed, the "purchaser or seller" rule of *Blue Chip Stamps* "has been reaffirmed hundreds of times . . . , and remains the rule in this Circuit and others." *MBIA Ins. Corp. v. Spiegel Holdings, Inc.*, No. 03 CV 10097, 2004 WL 1944452, at *2 (S.D.N.Y. Aug. 31, 2004), Whitney Decl., Ex. 46; *see also Lawrence v. Cohn,* 325 F.3d 141, 152 (2d Cir. 2003) (recognizing that the Supreme Court has "strictly limited standing to bring suit under § 10(b) to actual purchasers and sellers of a security and those plaintiffs with a *contractual* right to purchase or sell a security"). The insured-trustee is not a purchaser or seller with a purported direct Section 10(b) claim. Along the same lines, there is no evidence in this case that any loss associated with a purported Section 10(b) claim brought directly by a noteholder would be covered by Ambac as an insured claim.

Given the lack of connection between Ambac's insurance and the purported direct securities claims of noteholders, it is unsurprising that when the Honorable Gerard E. Lynch was presented with the same argument by another monoline insurer, the claim was rejected. In *MBIA*, the monoline insurer asserted that it had standing as a financial guaranty insurer of an asset-backed note offering to sue on behalf of the noteholders under Section 10(b) and Rule 10b-5. *MBIA*, 2004 WL 1944452, at *2-4, Whitney Decl., Ex. 46. The court rejected the argument, finding that MBIA was "simply an insurer," and not a *de facto* purchaser of the notes by virtue of its obligation to make payments to the noteholders in the event of a payment default by the special purpose entity created to securitize certain credit card receivables of its parent. *Id.* at *4. The Court held that granting standing to MBIA "under these circumstances would embrace precisely the sort of 'endless case-by-case erosion' [of the limitation on private right of action under the securities laws] that the Supreme Court rejected in *Blue Chip Stamps*." *Id.*; *see also Peltz v. D'Urso,* No. 92 Civ. 6457, 1993 WL 664621, at *1 (S.D.N.Y. Oct. 7, 1993) (holding that guarantor of mortgage note did not have standing to assert federal securities law claims and reasoning that "[p]ermitting Peltz to sue as a purchaser would subject the bright-line rule of *Blue Chip Stamps* to the type of 'case-by-case erosion' explicitly rejected by the Supreme Court"); *Rayman v. Peoples Sav. Corp.,* 735 F. Supp. 842, 849 (N.D. Ill. 1990) (denying defendants' leave to assert federal securities law counterclaims arising out of guaranty of purchase price on sale of business for lack of standing and holding that "clearly [defendants'] guaranty does not convert them into purchasers of the Shares for standing purposes").[2]

As in *MBIA*, if Ambac "had desired the right to bring securities fraud claims on behalf of the noteholders, it could have bargained for that right or charged higher premiums in its absence." *MBIA*, 2004 WL 1944452, at *5. Ambac did not do so, and Judge Katz correctly held that it would be entirely inappropriate for the Court to step in as a matter of "equity" to permit Ambac to assert the federal securities law claims of noteholders when it is the trustees who are the parties to the insurance agreements.

c. The Doctrine of Equitable Subrogation Is Inapposite to the Financial Guaranty Policies at Issue Here.

Ambac's effort to use the doctrine of equitable subrogation in this case is also antithetical to the purposes for that doctrine. Equitable subrogation was formulated to prevent unjust enrichment by enabling the insurer, despite a lack of privity between the insurer and the alleged wrongdoer, to seek reimbursement for the insurance payment from the alleged wrongdoer. *See Nobel Ins. Co. v. City of N.Y.*, No. 07 Civ. 01991, 2008 WL 4185738, at *4 (S.D.N.Y. Sept. 3,

[2] The court also rejected MBIA's policy arguments that it must be deemed to have standing to bring these claims, because otherwise no one would, since the transaction was structured in a way that gives the noteholders themselves no economic incentive to sue, in light of the insurance provided by MBIA. *MBIA*, 2004 WL 1944452, at *6. In rejecting this argument, the court "remain[ed] unperturbed by the abstract possibility that some potential category of securities lawsuits may be prevented from joining the rushing torrent of such suits currently filed in the federal courts. . . . Nothing in the outcome here offends justice or contravenes the legislative goals of the nation's securities laws." *Id.*

2008) (referring to equitable subrogation "as a legal bridge to allow a recovery between two parties who were *not* in privity").[3] Accordingly, "as an equitable doctrine, subrogation is designed to promote justice, and thus, is dependent upon the particular relationship of the parties and the nature of the controversy in each case." *Hamlet at Willow Creek Dev. Co. v. Ne. Land Dev. Corp.*, 64 A.D.3d 85, 106, 878 N.Y.S.2d 97, 112 (2d Dep't 2009).

Here, Ambac is not seeking equitable subrogation to overcome a lack of privity with EMC. To the contrary, Ambac and EMC, both sophisticated parties experienced in complex mortgage-backed securitization transactions, entered into a series of agreements carefully defining their respective rights and remedies, including subrogation.[4] As the Report correctly notes, "Ambac is able to be made whole directly by the party who is alleged to have caused the loss . . . ." (Report at 39.) Ambac's continued reliance on *Continental Insurance Co. v. Daewoo*

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[3] The cases Ambac cites applying New York law are consistent with the application of equitable subrogation to permit recovery between parties who are not in privity. *E.g., In re RLI Ins. Co.*, 97 N.Y.2d 256, 265, 740 N.Y.S.2d 272, 278 (2002) (insurance company was equitably subrogated to owner's rights against contractor with whom it was not in privity); *Hamlet at Willow Creek Dev. Co.*, 64 A.D.3d at 105-06, 878 N.Y.S.2d at 112 (holding that owner of construction site was equitably subrogated to reimbursement claim against a subcontractor with whom it "had no contractual obligation . . . whatsoever").

[4] Judge Lynch similarly noted in the MBIA case:

> MBIA's claims ring hollow in the context of a sophisticated commercial insurer who is in the business of providing 'financial guaranty insurance to the issuers of asset-backed securitizations [.] . . . The transaction documents here reveal even on casual perusal that the full economic risk of a default . . . would be borne by the Insurer.

MBIA, 2004 WL 1944452, at *4.

Shipbuilding & Heavy Machinery Ltd., No. 86 Civ. 5255, 1987 WL 16163 (S.D.N.Y. Aug. 21, 1987), is misplaced. As Judge Katz stated, "[t]here is no need or authority for this Court, acting in equity, to extend a single case's holding relating to subrogation in the context of maritime law and arbitration clauses, to allow Ambac, under New York law, to also pursue a federal securities fraud claim . . . ." (Report at 39) (distinguishing *Continental Ins. Co.*, 1987 WL 16163). This Court should adopt Judge Katz's recommendation not to apply the doctrine of equitable subrogation to allow Ambac to bring a securities fraud claim that belongs to neither insurer nor insured.

2. Judge Katz Correctly Denied Ambac Leave to Amend Its Complaint to Include a Tortious Interference Claim.

The Report correctly found that Ambac has not met the pleading standard of tortious interference with contract because of the clear applicability of the economic interest defense. (Report at 69.) Whether seen as a parent or affiliate of EMC, it is beyond doubt that Bear Stearns has an economic interest in EMC's affairs and its alleged interference with EMC's contracts is thus privileged. Indeed, Ambac concedes this point by alleging that Bear Stearns's motivation for allegedly reversing EMC's repurchase decisions was to reduce its accounting reserves or avoid bringing into its balance sheet EMC's liabilities, and that Bear Stearns pursued repurchase claims against originators in order to "generate recoveries." Proposed amended complaint ("PAC") ¶ 213. These cannot be interpreted as anything other than economic interests and are a complete defense to this alleged claim. *See Foster v. Churchill*, 87 N.Y.2d 744, 750-751, 642 N.Y.S.2d 583, 586-87 (1996) (quoting *Felsen v. Sol Café Mfg. Corp.*, 24 N.Y.2d 682, 687, 301 N.Y.S.2d 610, 613 (1969)) ("procuring the breach of a contract in the exercise of equal or superior right is acting with just cause or excuse and is justification for what would otherwise be an actionable wrong").

While Ambac recognizes the "economic interest defense," it nonetheless asks the Court to overlook this obstacle to its claim given the allegations that Bear Stearns purportedly used fraudulent and illegal means to effect the contract interference. (Ambac Obj. at 17.) The Report, however, correctly found that peppering the pleadings with conclusory allegations of fraud did not vitiate the defense —"Ambac has alleged nothing in its First Amended Complaint to suggest that JP Morgan [*i.e.* Bear Stearns] acted with any motivation beyond its own economic interest in refusing to repurchase loans . . . ." (Report at 63); *see, e.g.*, *Metro-Goldwyn-Mayer Studios Inc. v. Canal Dist. S.A.S.*, No. 07 Civ. 2918, 2010 WL 537583, at *8 (S.D.N.Y. Feb. 9, 2010) ("Defendants' business strategy, without some additional showing of malice or illegality, does not rise to the level of tortious interference with contract.").

Ambac's assertion that Judge Katz "recognized" that "Ambac adequately pleaded that JP Morgan [*i.e.*, Bear Stearns] engaged in *conduct* or *means* that interfered with Ambac's contract with EMC . . ." (Ambac Obj. at 17 (citing Report, at 63-64)), is patently false. In fact, after reciting Ambac's allegation in paragraph 205 of the PAC, the Report expressly notes that "[t]his amounts to nothing more than a 'formulaic recitation of the elements of [the] cause of action' and does not suffice to survive a motion for judgment on the pleadings. *Twombly*, 550 U.S. at 555, 127 S. Ct. at 1964-65." (Report at 64.) Therefore, contrary to Ambac's argument, it was not a lack of "specificity" regarding Ambac's intent that led Judge Katz to find the tortious interference claim futile (Ambac Obj. at 18), but rather a failure to plead "a set of facts . . . which, even if accepted as true, can be viewed as sufficient to support the claim that JP Morgan [*i.e.*, Bear Stearns] acted with malice, or employed a fraudulent or illegal means . . . ." (Report at 69.)[5]

In its Objections, Ambac points to an "across-the-board policy" to deny repurchase demands, and alleges that this was malicious and fraudulent because individuals at Bear Stearns purportedly knew that the loans should have been repurchased. (Ambac Obj. at 18-21.) This amounts to nothing more than a breach of contract allegation and was properly rejected. (Report at 65-66.) *See Armored Group, LLC v. Homeland Sec. Strategies, Inc.*, No. 07 CV 9694, 2009 WL 1110783, at *2 (S.D.N.Y. Apr. 21, 2009) (dismissing tortious interference claim where alleged conduct amounted to a breach of contract); *accord Kargo, Inc. v. Pegaso PCS, S.A. de C.V.*, No. 05 Civ. 10528, 2008 WL 2930546, at *10 (S.D.N.Y. July 29, 2008).

Ambac further argues that Bear Stearns's refusal to repurchase loans was part of a "fraudulent and illegal scheme to manipulate the accounting reserves that were required to be included on financial statements." (Ambac Obj. at 20.) That allegation of "fraud," however, does not appear anywhere in the proposed amended complaint, which simply describes an effort by Bear Stearns to reduce reserves and "by a corresponding amount its accounting liability." PAC ¶ 207. Ambac's conclusory allegation of "fraud" in its brief cannot salvage its proposed amended complaint which does not plead sufficient facts to meet the pleading standard articulated by the Supreme Court in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), *Ashcroft v. Iqbal,* 129 S. Ct. 1937 (2009), and the Second Circuit in *Iqbal v. Hasty*, 490 F.3d 143 (2d Cir. 2007). *See Wolf Concept S.A.R.L. v. Eber Bros. Wine and Liquor Corp.*, No. 07-CV-06233, 2010 WL 3258389, at *6 (S.D.N.Y. Aug. 17, 2010) (citing *Twombly*, 550 U.S. at 555) (where plaintiff's allegations are wrought with unsupported legal conclusions, "this is nothing more than "'a formulaic recitation of [the] cause of action' and does not suffice to survive a motion for judgment on the pleadings"); *Life Prod. Clearing, LLC v. Angel*, 530 F. Supp. 2d 646, 652 (S.D.N.Y. 2008) ("bald contentions, unsupported characterizations, and legal conclusions are not well-pleaded allegations'").[6] Thus, this Court should adopt Judge Katz's recommendation that Ambac's tortious interference claim is futile.

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[5] Ambac incorrectly contends that the Report applied the wrong legal standard in determining that its tortious interference was futile and instead should have made a determination whether Ambac asserts "colorable grounds for relief." (Ambac Obj. at 17.) But Ambac's reliance on the 1984 decision in *Ryder Energy Distribution Corp. v. Merrill Lynch Commodities, Inc.*, 748 F.2d 774, 783 (2d Cir. 1984), is misplaced because the Report correctly applied the more recent plausibility standards set forth in *Bell Atlantic v. Twombly*, 550 U.S. 563 (2007) and in *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009). Indeed, *Ryder* explicitly relies on *Conley v. Gibson*, 355 U.S. 41 (1957), which was specifically abrogated by *Twombly*, 550 U.S. at 563.

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[6] The Report correctly notes that "[i]n claims for tortious interference that have survived motions to dismiss, plaintiffs have, at a minimum, alleged some fact, above and beyond intentional interference." (Report at 64); *see, e.g., Medtech Prods. Inc. v. Ranir, LLC*, 596 F. Supp. 2d 778, 813-14 (S.D.N.Y. 2008) ("wrongful means" includes "physical violence, fraud, or misrepresentation, civil suits and criminal prosecutions, and some degree of economic pressure"). Thus, for example, in *Reed Construction Data Inc. v. McGraw-Hill Co.*, No. 09 Civ. 8578, 2010 WL 3835196 (S.D.N.Y. Sept. 14, 2010), plaintiff alleged that defendant hired contractors to pose as plaintiff's customers to misappropriate plaintiff's information. No such calculated or malicious scheme to undermine Bear Stearns's competitors is alleged here.

CONCLUSION

For all the foregoing reasons, the Court should adopt the Report's recommendations to deny Ambac's motion to amend to add a federal securities fraud claim and a tortious interference claim.

Dated: New York, New York
January 28, 2011

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CERTIFICATE OF SERVICE

I, Lauren C. Harrison, counsel for Defendant EMC Mortgage Corporation, certify that on the 28th day of January, 2011, I caused to be served the accompanying Defendant EMC Mortgage Corporation's Response to Plaintiff Ambac Assurance Corporation's Objections to Judge Katz's Report and Recommendation on its Motion for Leave to File an Amended Complaint upon counsel for Plaintiff, pursuant to agreement by the parties, by electronic mail to the following addresses:

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